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SUBJECT: UK ANNOUNCES 2008 BUDGET - KEY POINTS

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¶11. (U) Summary: Alistair Darling announced his first budget as Chancellor of the Exchequer on March 12. The budget forecast revised growth downward and predicted that inflation will rise above the Bank of England's two percent target. However, Darling took care to emphasize that the UK's economic fundamentals are strong and compare favorably with other G7 economies. As expected, Darling announced increased funding for the military. The non-dom tax changes will take effect in April as originally proposed despite months of protests from a plethora of business groups. HM Treasury (HMT) is sending out mixed signals on competitiveness by lowering corporation taxes while raising capital gains tax rates. The budget includes 800 million BPS (\$1.6 Billion USD) for the upstart clean technology fund. Darling highlighted HMG's cooperation with the U.S. on developing environmentally friendly technologies. Darling emphasized HMG's commitment to an open economy, trade and investment, and reiterated government support for the WTO DDA negotiations. End Summary.

Economic Forecasts

¶12. (U) Darling cut 2008 UK growth forecasts to 1.75-2.15 percent, compared to previous HMT forecasts of 2-2.5 percent. He expects growth to rise to 2.15-2.75 percent in 2009 and 2.5-3 percent in 2010. Darling forecasts inflation to rise above the Bank of England's 2 percent target in the short term as higher food and oil prices feed through into domestic inflation. However, he expects inflation to return to target in 2009 and to remain on target thereafter. Darling confirmed that the inflation target for the Monetary Policy Committee will remain at 2 percent on a CPI basis. The UK's current budget balance this year is in line with the Pre-Budget Report projection at minus GBP 8 billion (\$16 billion). Next year it will be minus GBP 10 billion (\$20 billion), returning to surplus in 2010 of GBP 4 billion. Borrowing is forecast to rise to GBP 43 billion (\$86 billion) next year, approximately 2.9 percent of national income, but is expected to fall to 1.3 percent by 2012/2013. Debt is projected to be 38.5 percent of GDP in 2008/2009 and 39.3 percent by 2012/2013. The Chancellor confirmed that the "Golden Rule" was being met with the current budget in surplus over the economic cycle. He said that borrowing for investment means that the second fiscal rule, the "Sustainable Investment Rule" would also be met each year and over the economic cycle.

Defense

¶13. (U) On the Defense Budget, Chancellor Darling announced that GBP 2 billion (\$4 billion) will be spent supporting UK troops on the front line. This will include approximately GBP 900 million (\$1.8 billion) on military equipment. In his speech to the House of Commons, Darling said that the Defence Budget has seen the longest

period of increased spending in a generation and he took the opportunity to pay tribute to UK service men and women in Iraq and Afghanistan.

Non-Doms

14. (U) Darling announced that the proposed non-dom tax changes will take effect in April as proposed in the pre-budget report and consultation paper. (add in reftels) He did not further elaborate, nor did he mention as expected anything on the creditability of the new taxes against U.S. tax liabilities. Darling emphatically announced that there will be no further changes during the next two parliaments.

(Note: The budget document (www.hm-treasury.gov.uk/budget) goes into slightly more detail confirming that any non-domiciled individual who was resident in the UK seven of the last ten years will either have to pay UK tax on their worldwide income or a 30,000 GBP (\$60,000 USD) tax charge if they wish to continue on the remittance basis of taxation. Previously, non-domiciled residents of the UK only had to pay UK income tax on their domestically earned income and any monies remitted into the UK. After the speech, an HMT official pointed us to an opinion by U.S. tax law firm Skadden Arps which concludes that the UK proposal should be creditable against U.S. taxes. The Skadden opinion is on the HM Revenues and Customs website, at www.hmrc.gov.uk/budget2008/bn107.pdf

Competitiveness

15. (U) Corporation tax will decrease to 28 percent from 38 percent starting in April 2008. Smaller firms will have simplified tax filing requirements. HM Treasury is, however, increasing the capital gains tax rate from 10 to 18 percent. This will apply to any disposal after April 6, 2008. However, Darling also announced an "entrepreneur relief" scheme. Any individual who disposes of a trading business or shares in a trading company will only pay 10

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percent capital gains tax as long as they are an employee or officer of the company and own at least a five percent stake in the firm.

Environment

16. (U) The Chancellor continued to stress the government's green credentials. He highlighted the BPS 800 million that the Treasury has dedicated to the Clean Technology Fund to assist developing countries with acquiring "green" technology and adapting to climate change. (Note: The Clean Technology Fund was first proposed by Sec. Paulson as an incentive for developing countries to reduce their emissions by adopting the latest technologies. It is part of the Major Economies Meetings process.) He also noted that BPS 26 million has been set aside for the Green Homes Service, a pilot project that helps homeowners with the installation of more efficient and energy-saving technologies, as well as the increase in the climate change levy in line with inflation. Darling also unveiled future initiatives, such as the re-introduction of a levy on single-use plastic shopping bags, a zero-carbon initiative for non-domestic buildings, a change to the vehicle excise tax that will favor more efficient vehicles, the inclusion of aviation emissions in the European Union Emissions Trading Scheme (EU-ETS), and the replacement of the biofuels duty differential with a Renewable Transport Fuel Obligation.

Housing

17. (U) HMG is pushing to make it easier for its citizens to purchase a home, which could have broader macroeconomic implications. Darling said they have identified potential sites for 70,000 new homes. HMG also wants to encourage more long-term fixed rate mortgages, which they believe will reduce risks for first-time home buyers. (Note: Currently, most mortgages in the UK have variable rates.) Darling also proposes easing loans for key workers, such as teachers and nurses, and reduces the property tax burden on new home buyers.

Comment

¶8. (SBU) There were few surprises in Darling's budget. The downward revisions to the economic forecast, the announcement of the non-dom tax changes, and the emphasis on climate change were widely expected. However, the lower corporation tax was new and, combined with the increased capital gains tax, sends a mixed message to the business community of the UK as a destination for investment.

TUTTLE